"Rally Mode"
Market Commentary – May 2003

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The stock market has yet to undergo a negative change of character since the high volume rally "buy signal" in mid-March. The market indexes continued to rally on high volume and pull back on low volume in April. This suggests that the probability of the market rising is still greater than the probability of the market declining.

Geopolitical uncertainty is still present, but it is not dominating Wall Street as much as last month. The financial markets correctly anticipated that the Iraq war would be short in duration. Remaining geopolitical uncertainty rests with Syria, Israel, Palestine, and North Korea. We are also keeping a watchful eye on the spread of SARS (Sudden Acute Respiratory Syndrome), the growth of which is weighing on international travel and trade. If these situations get worse, then the stock market will likely decline on high volume and undergo a negative change of character. We have yet to see this.

As expected, headlines are gradually moving from war to the economy, which is still mixed. GDP in the first quarter of 2003 grew 1.6%. While GDP growth was lower than the 2.3% expected by economists, the fact is that GDP grew. This illustrates the resilience of the U.S. economy in spite of geopolitical uncertainty and the threat of terrorism at home and abroad. Oil continues to hover below $30 per barrel as Iraqi oil flow resumed. Inflation registered a 1.7% year-over-year rise in March, the smallest increase since 1966. The absence of high inflation should help the Federal Reserve hold interest rates at a four-decade low. The Conference Board's measure of consumer sentiment spiked in April, with the uncertainty of the Iraq war lifted. The sentiment index was 81 in April, up from 62.5 in March. It will be interesting to see whether the improvement in sentiment translates into increased consumer spending.

Earnings are more positive than expected, but growth is due to cost-cutting, more so than revenue gains. With roughly one third of the S&P 500 companies having reported quarterly earnings as of April 21, earnings have beaten analysts' estimates by an average of 6.4%. These companies are on track to grow profits by more than 10% compared with last year. Cost-cutting is a difficult way to sustain earnings growth year after year, and this is a cause for concern.

Market technicals are bullish, while fundamentals are neutral – overall, we are mildly bullish on the market. The pattern of high volume rises and low volume declines is a bullish technical development. The major indexes, including the Dow Jones Industrials Average, Nasdaq Composite, S&P 500 large cap, S&P 400 mid cap, and S&P 600 small cap, have each taken out their respective 200 day moving averages. Nasdaq is showing the most strength, being the first index to have the 50 day moving average cross above the 200 day moving average. We are watching near-term resistance levels, however (950 on S&P 500, 9000 on DJIA, and 1500 on Nasdaq). Fundamentally, the market is still fairly priced, so we do not expect fundamentals to drive the indexes to new highs anytime soon. When we combine our technical and fundamental approaches with the seasonal weakness in stocks between May and October, we are mildly bullish on the equity markets.

Our portfolios are appreciating due to long positions in fundamentally strong stocks with bullish technical charts. Such confirmation by the market has signaled us to buy even more stocks on low volume declines. With the market nearing resistance levels, we have been actively writing covered calls to generate income until the market breaks out to the upside. Our portfolios are conservatively positioned with adequate cash, but we also have built diversified portfolios of undervalued stocks with bullish charts across many different industries. Until the market indexes show high volume declines, appreciation of our portfolios will justify us adding even more long equity positions.